TECHNICAL REPORT

Finance and Investment Protocol SADC

Assessment of Impact on Mozambique and Mozambican Private Sector

SUBMITTED TO
USAID/Mozambique

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Executive Summary

- The member states of SADC have concluded a Finance and Investment Protocol with the aim of accelerating growth, investment, and employment in the region through increased cooperation, coordination, and macroeconomic management.
- The objectives expressed are extremely broad, but there is little or no indication of how these will be achieved.
- In general the Protocol lacks clear targets, timing and decision making structures to define the detail it currently lacks. There are no enforcement mechanisms to ensure that unilateral behavior at member state level is sanctioned.
- Where desirable aspirations are expressed, these are bound by the limits of existing national legislation. It is therefore unclear how the protocol will effect progress in establishing a favorable investment climate as it does not force any change outside of the status quo.
- Provisions for the establishment of a Development Finance Network, a Development Finance Resource Center, and a Project Preparation Fund should be reconsidered. As currently drafted these are potentially bureaucratic and costly, and would do little to avoid the major risks of development finance (i.e., misallocation of funds).

Background

The government of Mozambique has asked CTA for its evaluation of SADC's proposal for the "Finance and Investment" protocol. Some of the objectives of the Finance and Investment Protocol are to

- Achieve macroeconomic convergence,
- Achieve tax harmonization in the region,
- Achieve currency convertibility in the region,
- Establish a network of Development Finance Institutions of the SADC Region, and
- Others (5).

[Finance and Investment Protocol of the Southern African Development Community - SADC, Page 13]

The overall objective of this activity is to assist the private sector of Mozambique in assessing whether the proposed protocol is necessary and positive for private sector development of Mozambique

Criteria for Assessment of Protocol

CTA is requesting technical assistance to provide a short-term consultancy to evaluate the proposed Finance and Investment Protocol of the Southern African Development Community (SADC). The consultancy needs to calculate its impact on the private sector including

- How the various proposals will affect Mozambique's competitiveness globally as well as within the SADC region;
- How the various proposals will affect Mozambique in regards to the cost and time of doing business; and
- The expected impact on investments and foreign trade.

The above especially in regards to tax harmonization; tax incentives; currency convertibility; and cooperation on investment—harmonization of investment regimes including policies, laws and practices.

- What are the expected cost and benefits to Mozambique of the proposed Finance Resource Center?
- What are the expected cost and benefits of the proposed SADC Development Fund?
- Prepare a comparison to accepted "Best Trade and Investment Promotion Practices."

Methodology

To assess the detail of the costs of the proposed Finance Resource Center, the DFI Network Activity, and the Development Fund, a field trip to Gaborone is necessary. The protocol as it stands gives no indication of proposed staffing levels, implied costs, or any method of cost allocation. I have, however, examined the overall proposal to establish these institutions and funds, and commented on the probable effectiveness of the proposed approach.

Likewise, to clarify ambiguities and discuss the rationale for some of the more questionable items in the protocol, it would be useful to visit Gaborone to discuss these with the individuals responsible for drafting the document. This has not yet been possible within my brief. During a recent field trip to Maputo, however, I attempted to discuss the document with members of the public sector and relevant agencies. None of these had actually read the document, and were not in a position to give any comments or opinions. I have therefore concentrated on assessing the proposals in the light of best global practice in investment promotion. I have discussed the protocol in detail with very senior managers of the Irish Investment Promotion Agency, who have also all had in-depth exposure to investment promotion throughout the SADC region through the establishment, training, and strengthening of national IPAs in the region. As indicated in the last section of this report, discussion of the document with existing and potential foreign investors in Mozambique would be useful.

General Comments

TOO MUCH TOO FAST?

The protocol is all-encompassing and aims to achieve an incredibly broad agenda:

- Facilitate regional integration and create a favorable investment environment.
- Achieve and maintain macroeconomic convergence.
- Cooperate and coordinate taxation, aiming to achieve tax harmonization within the region.
- Improve central bank governance standards aiming toward convergence in legal and operational frameworks, and also framework for cooperation and coordination on payment, clearing and settlement systems
- Establish a network of development institutions in SADC, collaborating on projects and ***pooling resources to finance projects***, take equity in each others institutions and ***invest jointly in new structures.***

It is questionable whether SADC has the institutional capacity to implement this degree of change effectively. There is a lack of clarity of vision as to what precisely the end point of this process should be, and a serious absence of a plausible implementation framework.

It is highly questionable whether regional integration in a region as economically diverse as SADC is a realistic objective. As reiterated throughout this document, the establishment of the region as a single market would contribute heavily towards attracting market-seeking FDI. Full integration of a region covering DRC through to RSA is a different matter.

There are no time indications anywhere on the protocol, and no measurable goal points, eliminating the possibility of a clear monitoring process. A more focused set of commitments with clear time indications would give a clearer and more credible signal to investors.

Comparing this to the EU approach towards integration, the EU had a far more incremental, systematic, step-by-step approach, as there are some building bricks that need to be in place before moving forward. For example, the legal framework to enforce any of the agreements in the protocol is still very weak—what are the powers of the tribunal referred to in Article 38 on Dispute Settlement?

ANY REAL PROGRESS?

Much of the document adds little to the status quo. Most of the articles take the form: "each member state shall in its own territory …… in accordance with its laws and regulations and in accordance with the Protocol." This is a problem in cases where Mozambican legislation/regulations are recognized to be deficient/obstructive to investment. For example, Article 2 (p. 30) on employment of Foreign Nationals. If this agreement is subject to members' laws on foreign nationals, there would be no automatic improvement on the current status quo as a result of the protocol, without changing domestic legislation in Mozambique. If anything, here and in many other places the protocol does not go far enough.

It could be argued that peer pressure would be created by the transparency that should arise from the shared information systems. This would highlight areas where Mozambique is deficient or suffers from overly restrictive regulation or legislation. That transparency, however, already exists through World Bank Climate Assessment, *Doing Business* report, and other reports, and is still only having a very slow impact on reform. Competition for investments is likely to prove a more effective and urgent tool for reform than any institutionalized compiling of statistics. If anything, the clause in Article 2 (p. 30) could be interpreted as calling for a potentially retrograde move.

Likewise, it is unclear how Article 4 (clause d, re Sourcing of Requisite Skills) would improve the currently inadequate situation. In fact, the wording in the protocol sounds like a potential argument in a favor of a return to the previous situation in Mozambique which required obligatory training of a local for each expatriate position.

DESIRABLE ASPIRATIONS—NO IMPLEMENTATION

Many of the other articles and commitments, while sensible in overall direction, are aspirational, lacking in clear definition and showing no real sense of implementation or achievement parameters. For example, no one will argue any more in SADC with: "The Host state shall facilitate and create favorable conditions to attract investments in its territory through suitable administrative measures and in particular in the matter of expeditious clearance of authorisations etc." The question is how and when, and there is no clear reason why signing this protocol would bring either closer. This applies to much of the section on cooperation on investment; local entrepreneur promotion and encouragement of linkages are great ideas, but the lack of any indicated strategies to achieve these goals leaves little credibility. In general, many of the provisions are not binding, lack firm commitments, and lack the measurable objectives that would allow a specific process for monitoring implementation of the protocol.

DECISION MAKING PROCESSES

It is unclear from the document as it stands what precisely the decision making processes and voting procedures are to further flesh out the provisions in the protocol. It is likewise unclear how the implementation process will work. For example, is it possible for one member of SADC to unilaterally decide not to sign up for a condition that they regard as too restrictive for their national FDI promotion campaign? For example, Annex 1 article 7 states that member states agree that it is inappropriate to encourage investment by relaxing health and environmental protections, and agree not to waive such restrictions to pursue investment. For such agreement to have any impact it has to be binding on all countries. What sanctions are imposed on countries who either fail to achieve what is agreed, or unilaterally decide not to adhere to a given clause? This may be because such a unilateral decision can lead to temporary gain of competitiveness (e.g., by evading environmental restrictions).

Positive Elements

LAUDABLE ASPIRATIONS

Much of the protocol expresses laudable aspirations, although how it will help in attaining them is considerably less clear. This observation applies to many of the articles (e.g., Article 6) agreeing to establish predictability and transparency.

RELIABILITY OF INVESTMENT CLIMATE

Agreements that contribute to the reliability of the investment climate (e.g., Article 3.3, p. 14, which commits to not arbitrarily change conditions and benefits from the letter of authorization) are obviously to be encouraged

TRANSPARENCY OF INVESTMENT POLICIES

This aspiration is expressed in Article 6: "Member States agree to promote and establish predictability, confidence, trust and integrity by adhering to ….transparent policies etc." A move to greater transparency for investment policies and details of implementation, such as criteria for EPZ status, incentives granted, etc., would be positive. As mentioned, however, it is difficult to see exactly how the protocol would help achieve these goals. These issues have long been identified as necessary to establish an attractive investment climate, but still have not been attained. It could be argued that the protocol will act as another pressure point to speed up reform and force transparency.

CONFIRMING NON-EXPROPRIATION/ REPATRIATION OF RETURNS

Some of the commitments (e.g., Articles 7 and 8, pages 14 and 15, on allowing repatriation of returns and committing to not expropriate) are simply prerequisite for FDI, other than for attracting very high-risk speculative opportunistic investments. These guarantees are already in the Legislation on Investment in Mozambique, so the protocol will make no difference to the current situation.

POLICY DEVELOPMENT—COMPETITION AND TRADE

Commitment to advance competition policy and trade openness is positive, subject to the usual reservation about implementation.

DOUBLE TAXATION AGREEMENTS

Establishing intra- and extra-regional agreements to avoid double taxation is positive and prerequisite for many projects

Reservations

DIVISION/ALLOCATION OF COSTS BETWEEN MEMBER STATES

Many of the proposed activities would obviously cost money (e.g., establishing and maintaining databases on many of the data sets proposed is not free). The question of who pays and how is unclear. This becomes particularly acute in the discussion of the proposed structures for development finance (e.g., how would the costs of the project preparation and development fund be allocated between member states?).

TAX HARMONIZATION/COOPERATION

The use of the term “tax harmonization” is potentially misleading, as most investors—at least from a European perspective—would interpret this as meaning a move to narrow bands of corporate tax rates. In the detail of the document it is clear that this degree of standardization of taxation is not intended. There is, however, a risk that investors would interpret the heading as a move in the direction of overall corporate tax harmonization. This would create uncertainty in investment projects currently in low tax bands. For three decades, the EU's emphasis on taxation has aimed to avoid market distortions (e.g., state aid to specific sectors/companies) and to further the single market and eliminate taxes that created barriers to trade. I would argue for replacing the heading "tax harmonization" with more precise language to eliminate the risk of sending a wrong message to investors.

Much of the "cooperation in taxation" section is innocuous enough, and would contribute to greater transparency. In theory, this should help reduce corruption. Some of the activities, however, could be costly and bureaucratic, such as the maintenance of the taxation database. Capacity building of tax officials would certainly be a good idea and less problematic, as presumably there would be donor funding available for this.

Most of the other tax provisions are moving to prepare for a more open trade regime, toward a fairer spread of the tax burden, and toward sensible cooperation on issues like smuggling, etc. VAT causes less distortion than excise duty as regards encouraging smuggling, which makes Clause 4, Article 6 on page 43 (Indirect Taxes) difficult to understand as this calls for the promotion of excise duty on an ad valorum basis.

The most potentially contentious area is tax incentives, but there is nothing in this document that would actually force any state toward a standardized tax incentive system. There is a commitment to "endeavour to avoid" harmful tax competition. This commitment is presumably deliberately vague, and the definition of harmful tax competition is equally loose (i.e., how low should the effective tax rate be to qualify as harmful?). There is a commitment to develop guidelines for tax incentives, but at no point is there anything binding, or any move towards standardization. In effect, other than generating a discussion about some of these issues, it is unclear what effect if any this section will have.

It is worth emphasizing that research indicates that tax incentives have a relatively poor record outside of Ireland, Malaysia, and Mauritius. All three of these countries have a strong sectoral FDI promotion policy and strategy. Mozambique lacks any clear investment promotion policy based on a full understanding of competitive advantage. In this context, investment incentives are not likely to be highly effective anyhow.

The consensus on tax incentives is that their effectiveness depends on the individual circumstances of the country, and indeed on the individual characteristics of the sectors targeted. It is clearly necessary for Mozambique to maintain the flexibility to use this tool accordingly. Nothing in this document removes that flexibility.

ROGUE STATE BEHAVIOUR

See discussion under "Decision making procedures."

INTELLECTUAL PROPERTY PROTECTION

The intellectual property protection clause is couched as being in accordance with agreements they are party to, so it is hard to see how this advances the status quo, other than in reiterating a commitment they have presumably already made under existing agreements. In light of the current and increasing crucial importance of protecting intellectual property as all sectors rely more and more on proprietary technology, this is simply not enough. The protocol should make an absolutely unambiguous commitment to adhere to world-class levels of IP protection as defined by WIPO.

MACROECONOMIC CONVERGENCE

While this would help strengthen trade links and underpin the moves towards an integrated regional market, it is probably far too early in the development of SADC institutional capacity, and not in the interests of Mozambique as one of the weaker regional players. Full convergence would mean surrendering control of national monetary policy. In some countries this is seen as a positive, as imposing restraint. But in the case of Mozambique economic policy has been regarded as prudent for the last decade, so this would not be a benefit.

The current strength of the *rand* and resulting loss of competitiveness in RSA exports, tourism, etc., is a good indicator of why this should be viewed with extreme caution. In a monetary union the *rand* would be the dominant currency, and in a strong Rand pushed upwards through commodity price increases, Mozambique would not have the flexibility to manage exchange rates to maintain competitiveness.

The "definition" of stability-oriented economic policies and even more so the indicators of macroeconomic convergence are suitably vague (i.e., no targets are yet quantified and no timing indicated, although Article 14 sketches the decision process through which these will be agreed).

DATABASE ON TAX INCENTIVES

There are potential arguments in favor of greater transparency here; however, it should be noted that sharing of this sort of competitive data is NOT a component of IPA activity in best practice examples of investment promotion. IPAs naturally commit some resources to monitoring competitors' incentive packages and all other competitiveness measures. This is usually done on a competitive basis in precisely the same way as companies in a given sector monitor each others' pricing and marketing. They do not establish databases to institutionally share this information.

DEVELOPMENT FINANCE INSTITUTIONS NETWORK

To my knowledge Mozambique does not have any institution that would be classified as a DFI, though there is naturally a strong lobby from the private sector to establish one. For Mozambique to participate in this network it would have to establish a DFI, which in itself could be the topic of a separate study.

For countries that already have a DFI, some of the network activities make sense (e.g., capacity building through moving personnel). I do not, however, see the benefit of many of the activities listed for the network. The network operates as a committee with relatively little power. The lending power remains with the national-level DFI. For example, the DFIs in the network are supposed to pool resources to finance a project in a single member state. It is difficult to imagine a commercially viable project in Mozambique of such magnitude that pooling makes sense. In pooling resources from 14 separate DFIs to lend to a national project, the committee of DFIs would have to appraise the project with all the competing national interests leaning on the management of individual DFIs. There would be no advantage in this pooling as regards raising capital on a SADC basis (i.e., they would not be accessing cheaper funding through risk diversification).

The network as it is sketched does nothing to avoid the main risks in DFIs (excessive influence from governments etc. on a national level, corruption, and bad debts due to misallocation of funding through cronyism or poor human capacity at the project appraisal level).

DEVELOPMENT FINANCE RESOURCE CENTER

This has apparently already been established. It could be used as a resource to examine the question of whether there is a model of a development finance entity that would work on a SADC level, without incurring the usual risks of displacing other lenders on good projects and/or bad debts (see below, alternative approach).

SADC PROJECT PREPARATION AND DEVELOPMENT FUND

The use of a fund to facilitate public sector employees in picking projects and developing business plans on these projects to present to potential investors is a complete waste of public money. This approach has long since been abandoned in more advanced countries, where the role of the state is at the most that of identifying which sectors are most likely to be able to develop competitive advantage. The public sector simply does not have the commercial experience to pick winners and evaluate them effectively in this way. On an organizational level even if this fund were a good idea, it is not clear who would manage this fund and the activities thereof.

ALTERNATIVE PROPOSAL ON DEVELOPMENT FINANCE COOPERATION

An alternative approach would be to establish on a SADC level, a professional investment bank-type structure, with the role of providing development finance to SADC projects on a disciplined commercially viable basis. This would replace the network of DFIs, and the Development Finance Resource Center would then be simply a section/departments (s) of the centrally based investment bank. The EIB in the European context could be a role model. The bank should be staffed by investment banker caliber personnel with appropriate banking and industry experience. This would have several advantages:

- Eliminate the need for the network of DFIs. This central structure be directly responsible for raising capital and lending onwards. It could build capacity by allowing national level DFI staff to go on stage to the SADC Bank.
- The useful proposed functions of the DFRC would then sit in the appropriate units within the SADC Bank.
- The Project Preparation fund would be eliminated. National-level project champions would develop the project to the stage where it is presented to the SADC bank for financing approval. This would reduce the risk of collusion, and introduce more discipline in project appraisal, assuming the SADC bank is staffed with appropriate personnel. As it is currently proposed the same entity is generating and financing projects, hence massively increasing the risk of fraud, corruption, inflated cost estimates, etc. It would also reduce the risk of national-level DFIs coming under political pressure at national level, as the funding decision is made elsewhere.
- The SADC Bank could also lend onwards to national-level DFIs where these exist, who could in turn lend onwards to local entrepreneurs. The advantage of this is that it would create an element of external scrutiny in the management of national DFIs, whereby DFIs that develop bad debt records simply get no further funding.
- The SADC Bank would raise capital at central regional level, and in doing so should be able to negotiate better terms through a decreased risk premium due to risk diversification between the 14 states.
- Despite the above it is probable that South African banks would still raise money more cheaply than the SADC Investment Bank. This means that South African projects would still be more likely to go to national lenders, which would avoid crowding out the other SADC players seeking financing.

Preliminary Conclusions

- The protocol lacks teeth. It is difficult to see how it will improve Mozambique's competitiveness and/or costs and time of doing business in the near term. Therefore, as a logical corollary, it is unlikely to cause any real improvement in Mozambique's ability to attract FDI.
- Much of what is proposed in the protocol does not correspond to best practice in investment promotion as practiced in European models. The Irish model has been followed in much of the development of Eastern European institutions for FDI promotion, and worldwide many IPAs have come to the IDA for training and consultancy help. I have discussed and confirmed the differences highlighted above with senior professionals directly responsible for establishing FDI promotion policies and strategies here and elsewhere.
- It would be an extraordinary challenge to implement all of the institutional changes and manage new institutions such as the Development Finance Resource Center effectively without risking serious misallocation of funds. I would be concerned about the cost-effectiveness of many of these proposals, and hence the cost burden they would place in Mozambican industry.
- The potential argument in favor of a central SADC institution, which would achieve cost economy via economies of scale, does not appear to work here because most of the proposed development finance institutions would duplicate rather than replace existing costs.
- The assumption that southern Africa would be made more attractive by grouping resources to promote it as a single region and potential destination for FDI is difficult to follow. Clearly opening regional trade barriers and creating a single huge market makes the area more attractive for FDI. But applying the same logic to FDI is akin to asking the entire car industry to pool its resources to do joint marketing—the theoretical advantage of more promotional effectiveness through pooled resources would be lost in the wasteful bureaucracy, and the loss of targeted competitive action.
- If the identified problem is that the region is suffering from an image problem that would lend itself to a concerted pooled resource campaign, the obvious question is why the region is suffering. The general answer from all survey data can be summarized as ***excess risk***. Data show that returns from the region for those who do invest are on average very high, but the perception of excess risk remains, hence reducing the attractiveness of the returns. Concerted efforts on the risk mitigation front (risk insurance mechanisms) would perhaps yield more than the potentially costly measures suggested here.
- In general, the assumption that totally leveling the playing field and creating across-the-board transparency will lead to equal advantage for all is inherently flawed, as the less

competitive countries will automatically lose out to the more competitive entity, in this case South Africa.

Possible Further Work

A quick and dirty survey of investors in footloose FDI categories could easily be carried out to determine if the protocol will have any impact on their investment decision making. Do they expect it to effect any real change in the investment climate in Mozambique that would make the country more attractive for potential future investments? The opinions of existing FDI investors in Mozambique could also be elicited.

Discussion with the team in Gaborone and individuals in Mozambique who were responsible for drawing up the existing document would provide insight into the rationale of existing clauses, previous discussions and sensitivities, and potentially trade-offs that have been made. Some reservations expressed here are due to a lack of clarity that could easily be remedied by direct discussion.

Appendix. Issues for Clarification

Several errors and ambiguities in the document, such as inaccurate cross-referencing to previous articles, clauses, etc., make it hard to follow. These are listed here for reference and as points for possible direct discussion with the document's authors.

- Article 5.2—The aspiration to "eventually harmonize domestic policies and legislation within the spirit of non-discrimination"
- Article 9.1—Promote regional cooperation in the area of investment (what exactly does this mean?)
- Article 10—No measures in targets for macroeconomic convergence
- Article 16 1.d—What exactly are the tax treaties?
- Article 27—Cooperation on development finance—Who is funding the development finance institutions and are these in fact already established?
- Article 28—What is the rationale of taking equity in each others' institutions? Invest jointly in new structures—What does this mean? Collaborate on the establishment of appropriate institutions
- Numbering in many cases unclear —Difficult to follow cross-references to articles and clauses. For example, Article 2.2 referred to on page 14; it is unclear precisely which article is referred to—Is it Article 4?
- Article 5-5.1—Leaves open the right to grant preferential treatment to qualifying investments and investors in order to achieve national development objectives. I assume this includes tax treatment.
- What is meant by page 22, Article 30, SADC Project Preparation and Development Fund - as provided by Article 26A of the Treaty?
- Does Mozambique have a "Development Finance Institute" which is part of the network, and have they signed up to the DFI MOU?
- Constant references to treaty—What treaty?